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Report Highlights: Thanks to a surge in milk deliveries in April, NZ's raw milk and dairy commodities production in 2002/2003 will increase 3 and 6 percent, respectively. Increased milk output together with a large carry-over from the prior season allowed NZ to export a record volume last year. Export sales were made at sustainable prices, partly as a result of reduced Australian competition.

Includes PSD changes: Yes
Includes Trade Matrix: Yes

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SECTION I. EXECUTIVE SUMMARY

The New Zealand dairy industry benefitted from the drop in Australian milk output in the current 2002/2003 season and achieved record export sales. This was accomplished without reversing the modest international dairy commodity price recovery that began in the second half of calendar 2002. Fonterra's export sales, particularly during the first half of the 2002/2003 season, took full advantage of large product inventories carried over from the prior season. Despite an increase in shipping volume, the appreciation of the New Zealand dollar resulted in a marked drop in earnings in 2002/2003 in terms of local currency. Fonterra has addressed this currency risk by hedging all forecast revenues for a period of 15 months, effective May 1, 2003.

Because of the significant drop in earnings, Fonterra has temporarily put on hold new plans for the expansion of its international operations. This reflects Fonterra's preference for funding its expansion programs utilizing internal resources. Until such time that its revenue stream improves, Fonterra will focus its efforts on consolidating existing investments, developing its Australian operations, and becoming an active supporter of international trade liberalization to improve market access for its dairy products.

The forecast reduction in milk payouts to Fonterra's suppliers made at the start of the season had only a small limiting effect on dairy herd expansion and growth in milk production in 2002/2003. Early season milk output was curbed by adverse spring weather followed by dry summer conditions. This, however, was offset by record milk volumes produced during April 2003 which yielded a 3 percent increase in total seasonal milk production to 14.346 million tons.

Combined production in 2002/2003 of cheese, butter, skim milk powder (non-fat dry milk), and wholemilk powder is forecast to increase 6 percent. A change in Fonterra's product-mix emphasized a shift from cheese to wholemilk powder (WMP) production, and from casein to butter and skim milk powder (SMP). Cheese production in 2002/2003 fell 13 percent, but increases of 10 percent for butter, 16 percent for SMP, and 8 percent for WMP were recorded.

Overall, dairy product export sales during 2002/2003 are forecast to increase 13 percent to 1.57 million tons. New Zealand's cheese exports are forecast to remain static at around 280,000 tons, and given a decline in this year's production, will result in a significantly reduced end-of-season stock level. New Zealand's butter exports are forecast to increase 6 percent to 365,000 tons. SMP and WMP exports in 2002/2003 are forecast to increase 25 percent and 17 percent, respectively. The higher export volumes will result in marked reductions for 2002/2003 end-of-season inventories.

Fonterra forecasts a final payout for the 2002/2003 season of NZ \$3.60 (U.S. \$2.02) per kg. of milksolids (MS), a third lower than a year earlier. Westland (accounting for 2.5 percent of national production) and Tatua (accounting for 1 percent of national production) project their final payouts to be NZ \$0.40 - 1.50 (U.S. \$0.22 - 0.84) per kg. MS higher. Westland is known for its low reject rates associated with poor product quality while Tatua is a niche manufacturer of mainly protein-based functional products. Fonterra's current payout prediction for the 2003/2004 season is N.Z. \$3.70 to 3.90 per kg. MS.

Fonterra plans to replace its controversial peak notes scheme under which suppliers with steep milk curves contribute additional capital to process their excess milk. A new capacity adjustment scheme will be introduced whereby suppliers with a steep milk curve will cover Fonterra's higher processing costs through a reduced end-of-season payout. The changes will become effective in the 2004/2005 season if sufficient shareholder support is achieved.

The "Clean Streams Accord" between Fonterra and the Government of New Zealand will be implemented in June 2003 (see NZ2035). The Accord identifies environmental and animal welfare targets but is not legally binding. The Accord was initiated by Fonterra last year because of the perceived threat of New Zealand dairy farm practices to the clean and green environmental image overseas consumers associate with New Zealand dairy products. In addition to the Clean Streams Accord, Fonterra will introduce an Environmental Assessment scheme (Dairying Accord). It is likely to become part of Fonterra's dairy producer supply terms in the 2004/2005 season and producer compliance will be compulsory. Suppliers reportedly are unenthusiastic about this new Accord.

SECTION II. STATISTICAL TABLES**PSD Table: Fluid Milk**

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Fluid				(1000 HEAD)(1000 MT)	
	2001	Revised	2002	Estimate	2003	Forecast
	USDA Official[O ld]	Post Estimate[New]	USDA Official[O ld]	Post Estimate[New]	USDA Official[O ld]	Post Estimate[New]
Market Year Begin		06/2000		06/2001		06/2002
Cows In Milk	3557	3557	3749	3749	3844	3953
Cows Milk Production	13162	13162	13925	13925	14204	14346
Other Milk Production	0	0	0	0	0	0
TOTAL Production	13162	13162	13925	13925	14204	14346
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	13162	13162	13925	13925	14204	14346
Intra EC Exports	0	0	0	0	0	0
Other Exports	42	42	48	48	48	60
TOTAL Exports	42	42	48	48	48	60
Fluid Use Dom. Consum.	355	355	355	355	355	360
Factory Use Consum.	12723	12723	13480	13480	13759	13884
Feed Use Dom. Consum.	42	42	42	42	42	42
TOTAL Dom. Consumption	13120	13120	13877	13877	14156	14286
TOTAL DISTRIBUTION	13162	13162	13925	13925	14204	14346
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	12	12	0	0	0	0

PSD Table: Cheese

PSD Table						
Country	New Zealand					
Commodity	Dairy, Cheese				(1000 MT)	
	2001	Revised	2002	Estimate	2003	Forecast
	USDA Official[O ld]	Post Estimate[New]	USDA Official[O ld]	Post Estimate[New]	USDA Official[Ol d]	Post Estimate[New]
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	34	34	27	43	43	50
Production	281	281	312	312	270	272
Intra EC Imports	0	0	0	0	0	0
Other Imports	2	2	0	0	0	0
TOTAL Imports	2	2	0	0	0	0
TOTAL SUPPLY	317	317	339	355	313	322
Intra EC Exports	0	0	0	0	0	0
Other Exports	267	251	268	277	260	280
TOTAL Exports	267	251	268	277	260	280
Human Dom. Consumption	23	23	28	28	28	28
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	23	23	28	28	28	28
TOTAL Use	290	274	296	305	288	308
Ending Stocks	27	43	43	50	25	14
TOTAL DISTRIBUTION	317	317	339	355	313	322
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	32	32	38	38	50	48

PSD Table: Butter

PSD Table						
Country	New Zealand					
Commodity	Dairy, Butter				(1000 MT)	
	2001	Revised	2002	Estimate	2003	Forecast
	USDA Official[O ld]	Post Estimate[New]	USDA Official[O ld]	Post Estimate[New]	USDA Official[Ol d]	Post Estimate[New]
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	72	72	50	50	15	51
Production	352	352	321	370	345	405
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	424	424	371	420	360	456
Intra EC Exports	0	0	0	0	0	0
Other Exports	347	347	331	343	315	365
TOTAL Exports	347	347	331	343	315	365
Domestic Consumption	27	27	25	26	25	26
TOTAL Use	374	374	356	369	340	391
Ending Stocks	50	50	15	51	20	65
TOTAL DISTRIBUTION	424	424	371	420	360	456
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	21	21	27	27	19	21

PSD Table: Non-Fat Dry Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Nonfat Dry				(1000 MT)	
	2001	Revised	2002	Estimate	2003	Forecast
	USDA Official[O ld]	Post Estimate[New]	USDA Official[O ld]	Post Estimate[New]	USDA Official[Ol d]	Post Estimate[New]
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	71	71	98	98	85	100
Production	227	227	237	255	285	295
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	298	298	335	353	370	395
Intra EC Exports	0	0	0	0	0	0
Other Exports	195	195	245	248	265	310
TOTAL Exports	195	195	245	248	265	310
Human Dom. Consumption	5	5	5	5	5	5
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	5	5	5	5	5	5
TOTAL Use	200	200	250	253	270	315
Ending Stocks	98	98	85	100	100	80
TOTAL DISTRIBUTION	298	298	335	353	370	395
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	1	1	1	1	2	1

PSD Table: Dry Whole Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Dry Whole Milk Powder				(1000 MT)	
	2001	Revised	2002	Estimate	2003	Forecast
	USDA Official[O ld]	Post Estimate[New]	USDA Official[O ld]	Post Estimate[New]	USDA Official[Ol d]	Post Estimate[New]
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	52	52	20	20	38	33
Production	480	480	540	540	560	585
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	532	532	560	560	598	618
Intra EC Exports	0	0	0	0	0	0
Other Exports	511	511	521	526	545	615
TOTAL Exports	511	511	521	526	545	615
Human Dom. Consumption	1	1	1	1	1	1
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	1	1	1	1	1	1
TOTAL Use	512	512	522	527	546	616
Ending Stocks	20	20	38	33	52	2
TOTAL DISTRIBUTION	532	532	560	560	598	618
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	4	4	4	4	3	3

Trade Matrix: Cheese

NEW ZEALAND DAIRY EXPORTS			
Calendar Years			
CHEESE (tons)			
Destination	2000	2001	2002
United States	32,356	38,203	47,735
Japan	49,955	54,599	44,459
Australia	31,484	40,170	40,128
Belgium	16,367	19,057	19,169
United Kingdom	11,625	14,832	17,016
Mexico	10,466	11,292	13,462
Korea, South	9,132	12,056	10,307
Saudi Arabia	5,301	8,281	9,737
Algeria	5,970	6,407	8,267
Egypt	5,727	6,508	6,190
Taiwan	6,158	4,955	5,953
Hong Kong	3,732	4,314	3,854
Venezuela	2,884	4,091	3,586
Philippines	2,818	2,457	3,324
Jamaica	4,755	5,736	3,324
Malaysia	2,346	2,893	3,014
Panama	1,195	2,869	2,684
Other	35,645	38,710	37,554
TOTAL	237,915	277,430	279,762
Source: Statistics New Zealand			

Trade Matrix: Butter

NEW ZEALAND DAIRY EXPORTS			
Calendar Years			
BUTTER (tons)			
Destination	2000	2001	2002
Belgium	41,605	34,701	68,938
Iran	30,238	15,225	33,623
Egypt	24,417	24,095	32,928
Russia	7,183	3,656	25,110
Mexico	17,461	21,011	23,388
United States	19,711	26,598	21,049
Latvia	15,374	15,565	20,349
United Kingdom	39,019	37,613	18,885
Canada	11,408	18,113	14,401
India	7,104	617	11,569
Taiwan	10,597	8,971	10,829
Morocco	7,016	5,938	8,951
Singapore	16,023	4,914	7,731
Thailand	2,407	3,915	7,487
Saudi Arabia	6,593	5,170	7,049
Algeria	2,834	5,184	6,346
Australia	9,822	10,065	6,337
Indonesia	3,638	3,803	6,278
Hong Kong	6,784	8,845	5,985
China	613	1,346	5,847
Other	68,645	47,990	58,216
TOTAL	348,491	303,335	401,295
Source: Statistics New Zealand			

Trade Matrix: Non-Fat Dry Milk

NEW ZEALAND DAIRY EXPORTS			
Calendar Years			
NON-FAT DRY MILK (tons)			
Destination	2000	2001	2002
Japan	13,714	18,513	29,740
Mexico	3,174	4,414	25,538
Philippines	20,271	29,480	25,297
Indonesia	14,004	18,686	24,200
Thailand	5,851	15,277	23,444
Malaysia	20,804	24,727	20,895
China	5,981	7,061	20,084
Taiwan	16,805	19,789	14,250
Vietnam	5,900	9,301	13,664
Algeria	0	315	13,101
Saudi Arabia	11,834	11,170	12,650
Germany	0	0	12,533
Belgium	0	159	12,047
Netherlands	132	369	8,905
Singapore	4,075	3,084	8,206
Cuba	0	10,167	6,346
Hong Kong	9,848	9,669	5,246
Egypt	3,333	4,760	4,349
Other	29,729	37,409	41,900
United States	638	936	1,485
TOTAL	166,094	225,285	323,882
Source: Statistics New Zealand			

Trade Matrix: Whole Milk Powder

NEW ZEALAND DAIRY EXPORTS			
Calendar Years			
WHOLE MILK POWDER (tons)			
Destination	2000	2001	2002
China	23,652	29,720	56,310
Malaysia	61,092	44,265	49,968
Indonesia	44,624	51,464	43,105
Philippines	24,835	35,382	39,007
Mexico	7,212	40,588	30,767
Thailand	30,578	31,818	30,486
Sri Lanka	27,705	31,857	30,331
Saudi Arabia	17,375	21,007	27,598
Brazil	3,209	1,209	24,714
Taiwan	18,375	21,127	21,878
Venezuela	29,954	44,895	21,756
Canada	10,502	11,812	21,696
Singapore	17,975	8,283	17,685
Cuba	3,044	10,864	16,745
Algeria	7,618	7,589	15,978
Vietnam	20,908	57,869	14,273
El Salvador	16,234	17,512	14,106
Jordan	0	500	13,584
Australia	8,213	7,561	8,911
United Arab Emirates	9,064	5,995	8,768
Oman	993	753	8,599
Other	69,093	70,601	81,790
United States	4,113	3,558	3,474
TOTAL	456,368	556,231	601,530
Source: Statistics New Zealand			

SECTION III. PRODUCTION, CONSUMPTION & TRADE

Production

New Zealand's milk production for the 2002/2003 season (June-May) is estimated to increase 3 percent to 14.346 million tons. Three quarters of this growth in milk volume will occur in the South Island. Earlier in the season, the New Zealand dairy industry predicted milk production increases of 1-2 percent due to an unusually cold spring (September and October 2002) and the development of very dry conditions during summer and autumn in major New Zealand dairy production areas. However, in late February adequate rain stimulated pasture growth in the northern regions of the North Island leading to a record national milk production in April.

Combined production of cheese, butter, skim milk powder (non-fat dry milk), and wholemilk powder is forecast to increase 6 percent. The disproportionate increase in commodities production is driven by a change in product-mix emphasis. Cheese production has been replaced with wholemilk powder production, and casein production has been replaced with butter & skim milk powder production. Production will decrease for cheese (13 percent) but increase for butter (10 percent), skim milk powder (16 percent) and whole milk powder (8 percent).

Productive Factors

The New Zealand dairy herd continues to grow, albeit at a reduced rate. Approximately 100,000 additional cows joined the New Zealand milking herd as of June 2002¹. Growth of the South Island and North Island dairy herds reflects the ongoing North-South shift in dairy production with South Island and North Island milking cow numbers increasing 7 and 1 percent, respectively. Productivity gains appear to be the main driver behind this trend. The average herd and farm size is now more than 50 percent larger in the South Island. While the average stocking rate on South Island farms is 4 percent lower, this is outweighed by higher milksolids (MS) production per cow (12 percent higher) and higher MS production per hectare (7.5 percent higher).

Over the last ten years improved animal genetics, more productive pasture species and better animal husbandry and pasture management practices have helped to increase New Zealand's dairy cow production from 270 kg. to over 300 kg. MS per cow. Climatic conditions continue to impact strongly on season-to-season production but the New Zealand dairy herd has experienced ongoing productivity increases. The industry's aim is to continue to achieve annual productivity increases of 2-3 percent.

Consumption

¹ Please note that PSD Table indicates a larger increase. This reflects recent agricultural census data from Statistics New Zealand which estimates New Zealand's milking cow numbers 3 percent above previous Ministry of Agriculture and Forestry estimates. This shifts baseline dairy cow numbers to which increases due to dairy farm conversions and herd expansions must be added.

Per capita consumption of traditional dairy products in the domestic market is static and unlikely to experience any significant growth, but a continuation of current net immigration would increase total domestic consumption 1 percent annually. Per capita consumption increases may be achievable in the undeveloped domestic market for advanced biofunctional (probiotic) dairy ingredients and products, though, once consumer demand and domestic/international supply sources can service the New Zealand market.

Trade

The significant increase of New Zealand's milk production, especially in the latter part of the 2001/2002 season, led a considerable buildup of New Zealand dairy product inventories. Fonterra began to export these stocks during the current season and managed to do so without causing a reduction in international dairy commodity price levels, which was aided by lower Australian production. By the end of the 2002/2003 season, combined stocks (cheese, butter, SMP, WMP) are forecast to decrease 30 percent. Overall, export sales during 2002/2003 are forecast to increase 13 percent to 1.57 million tons.

Cheese

New Zealand's cheese production is forecast to decrease 13 percent to 272,000 tons in 2002/2003. Export sales are forecast to remain static at 280,000 tons. This will lead to a significant reduction in stock levels. The decrease of cheese production is attributed to lower international price levels relative to powders and the difficulty in holding cheese stocks long term. The trend in lower cheese production is expected to continue as price levels remain the same relative to powders.

Butter

New Zealand's butter production is forecast to increase almost 10 percent to 405,000 tons in 2002/2003. Exports are forecast to increase 6 percent to 365,000 tons over the same period. Much of the increase will be absorbed by exports to Belgium, Iran, Egypt and Russia. With static domestic butter consumption stocks will increase modestly. High butter stocks in the United States and the EU will constrain export increases and possibly lead to increased New Zealand stocks in the 2003/2004 dairy season.

Skim Milk Powder

Skim milk powder (SMP) production in 2002/2003 is forecast to increase 16 percent to 295,000 tons. This increase is accompanied by a 25 percent increase in exports to 310,000 tons which will lead to a significant reduction in SMP stock levels.

Whole Milk Powder

Whole milk powder (WMP) production is forecast to rise 8 percent to 585,000 tons, while exports are forecast to increase 17 percent to 615,000 tons. Exports to China, the most important export customer, will increase significantly. WMP stocks will be at minimum levels at the end of the 2002/2003 season.

Farmgate Prices

Fonterra forecasts a final payout for the 2002/2003 season of NZ \$3.60 (U.S. \$2.02) per kg. MS less 3 cents for industry good activities. Weaker international commodity prices and a stronger New Zealand dollar are the primary reasons for the significant payout reduction, which is down more than 30 percent from last season's (the final payout figure for 2002/2003 will be announced in June). Meanwhile, Westland (2.5 percent of N.Z. production) and Tatua (1 percent of N.Z. production) expect their final payouts to be N.Z. \$3.90 to NZ \$4.00 (U.S. \$2.20) and N.Z. \$5.00 - 5.10 (U.S. \$ 2.80 - 2.86) per kg. MS, respectively. Fonterra's current payout prediction for the 2003/2004 season is N.Z. \$3.70 to 3.90 per kg. MS.

SECTION IV. STRATEGY & POLICY

Investment Consolidation Replaces International Expansion As Payouts Decline

Aspirations to global dairy industry leadership have been repeatedly stated by Fonterra since its formation in 2001. According to its business strategy, achievement of this leadership position requires annual growth of 13-15 percent over the next ten years. Due to significant trade barriers New Zealand dairy products are facing in overseas markets, annual growth will come from international acquisitions, mergers, and joint ventures (see NZ2013 & NZ2035) and not from New Zealand-based dairy export increases. However, after a period of international expansion, additional expansion plans seem to be put on hold. Instead, Fonterra emphasizes consolidation of its Australian dairy industry investments and its role as an active supporter in liberalizing global agricultural trade through the WTO.

Responsible for this change in emphasis, according to industry analysts, is the decline in international dairy commodity prices and unfavorable exchange rate developments both of which have significantly reduced Fonterra's net revenue. A lack of internal funds has, consequently, curbed Fonterra's ability to finance new international expansion projects. Two options of financing expansion from external sources are also unlikely. Raising debt appears unlikely due to Fonterra's equity to debt ratio. Fonterra could also attempt to attract outside investment but its current co-operative ownership structure makes this unlikely as Fonterra has repeatedly stated that it is not inclined to suggest changes to it. Consequently, Fonterra is probably going to hold off from further expansion until the financial situation improves. The achievement of operational efficiencies and stronger commodity prices will be key to this.

A possibility to achieve the company growth target in the meantime is to increase New Zealand milk production. However, protectionist policies in lucrative export markets will make it difficult to market additional milk production profitably. As a consequence of these issues, Fonterra is (1) pursuing an active role in New Zealand's WTO-based agricultural trade liberalization efforts, and (2) consolidating its Australian investments. Australia and New Zealand each hold 40 percent of world market trade in dairy products. Consequently, Fonterra has good reason to seek more influence and control in Australia, firstly by creating a larger home market for its own products and secondly by gaining more control over world trade in dairy products.

Fonterra Offers 10 Percent Price Premium for Organic Milk Supplies

Fonterra aims to grow its organic milk category by offering an incentive to suppliers of organic milk. The incentive is in the form of a 10 percent per kg. MS premium above its normal seasonal payout. The premium is offered to recognize the additional costs associated both with organic milk production and conversion to an organic production system. Fonterra is planning the expansion of the current base of 17 organic milk suppliers to 250 mainly in the Waikato region (North Island). To date, an additional 70 farms have registered their interest. The main challenge for Fonterra is to source enough organic milk to run their large manufacturing plants efficiently. Eight manufacturing plants produce organic cheese, milk powders, butter, and milk protein concentrates. Fonterra's customers are in Australia, Europe, and Northern Asian markets, which are particularly interested in organic infant formula, cheese and fresh milk. The United States organics market is cited as the potentially most important. Fonterra will be seeking USDA certification for the use of the USDA Organic Seal in the near future.

Fonterra Proposes Changes to Peak Notes Scheme

Fonterra has initiated steps to replace its controversial peak notes scheme under which suppliers with steep milk curves (those that peak above the milk supply curve of an average supplier) have to contribute more capital to process the additional milk by purchasing additional peak notes². Instead, under a new capacity adjustment scheme suppliers with a steep milk curve will meet the higher annual financing costs of the extra manufacturing capacity required to process the additional milk through an end-of-season payout reduction. Correspondingly, suppliers who decrease required financing cost because they have a flatter milk supply curve will receive a higher payout. Fonterra believes that 90 percent of suppliers would experience payout adjustments of \pm NZ 3.5 cents per kg. milksolids.

At the transition to the new scheme peak notes would be converted into Fair Value Shares, raising the unit value by the average peak note cost (NZ 95 cents) from NZ \$3.85 to NZ \$4.80 (U.S. \$2.16 to 2.69) per kg. of milksolids. Under the capacity adjustment scheme all suppliers would then hold the same capital per kg. of milksolids in Fonterra irrespective of their milk curves. However, suppliers who

²Apart from being criticized by suppliers for being too complex to understand, the peak notes scheme has also created the situation in this season in which farmers in the Taranaki region have to purchase additional peak notes as the drought conditions have lowered overall milk production thereby steepening their supply curves.

hold less than the average peak note cost of NZ 95 cents per kg. of milksolids, ie. generally those with a flatter milk supply curve, would have to finance the difference. Suppliers who hold more than NZ 95 cents in peak notes would be compensated by Fonterra.

The proposal will be presented at Fonterra's annual meeting in September where 75 percent of shareholder support is needed to implement the proposed changes. Provided the proposal receives sufficient support, the changes could become effective in the 2004/2005 season. The capacity adjustment scheme does not require changes to the Dairy Industry Restructuring Act, according to Fonterra.

Fonterra Implements Modified Foreign Exchange Hedging Policy

Fonterra has implemented a new foreign exchange hedging policy which will protect 100 percent of Fonterra's projected foreign exchange earnings against spot market currency movements. Under the policy (which has been in place since May 1 2003) Fonterra will enter each month into standard forward exchange contracts to sell U.S. dollars (and other currencies) to the total value of Fonterra's projected earnings 15 months later. This means that at the end of each month all of Fonterra's projected foreign exchange earnings for the next 15 months will be protected against spot market currency movements. Fonterra has chosen not to take out any forward contracts beyond 15 months because sales volumes and prices are too difficult to predict over a longer period of time.

The policy will not lock suppliers into the hedging regime. They continue to be able to manage their own hedging position. Each month Fonterra will publish its currency exposure on a 'per kilogram of milksolids' basis. Fonterra calculates this exposure each month by dividing its projected sales revenue (in U.S. dollars) by the amount of milksolids forecast to be sold. Suppliers can then estimate their own milksolids production and determine their exposure for that month. Based on this information suppliers can take out their own hedging position. Anecdotal evidence suggests that up to five percent of suppliers have been doing this in the past.

Under the new policy Fonterra will no longer speculate on future exchange rates. The previous hedging policy provided up to 70 percent cover over 12 months and up to 30 percent cover over 13 to 24 months. This exposure to spot market currency exchange fluctuations was one reason for payout reductions in the current season. The New Zealand dollar appreciated 20 percent against the U.S. dollar over the last 6 months.

"Clean Streams Accord" Provisions Likely to Become Part of Milk Supply Contract

An environmental and animal welfare agreement of intent, the "Clean Streams Accord", between Fonterra and government agencies will be implemented in June this year. The Accord identifies five environmental and animal welfare areas in which dairy farmers will be expected to meet certain minimum targets, but the agreement is not legally binding. However, along with the Accord, Fonterra will introduce an Environmental Assessment scheme (Dairying Accord). That scheme will set the same

five targets, among other dairy industry guidelines, against which suppliers will be assessed. Fonterra has also indicated that these targets are likely to become part of the 2004/2005 season terms of supply. The exact nature of the new terms are still being developed, but they will be designed to encourage farmer compliance. This is likely to be in the form of specific actions that Fonterra can take depending on the duration and degree of non-compliance by individual farmers. Fonterra stresses that only targets are set at this stage and that best farm management practices are encouraged by providing advice and guidance to farmers to meet the targets. However, Fonterra reserves the right to introduce specific company standards, as opposed to targets, if this helps to retain or enter new markets.

The Accord was initiated by Fonterra last year because of the perceived threat of New Zealand dairy farm practices to the clean and green environmental image overseas consumers associate with New Zealand dairy products (NZ2035). Fonterra is particularly concerned with the increasing negative publicity dairy farming practices receive in the local and international media. The Accord is also in response to dairy farming's real impact on water quality, which has been documented in several New Zealand studies.

Many Fonterra's suppliers are unenthusiastic about the Accord because its targets will become mandatory in the milk supply contract³ and that will add unnecessary compliance costs. New Zealand's premier farmer lobby group, Federated Farmers of New Zealand, which represents almost 17,000 farmers, also strongly opposes implementation of the Accord. It argues that it unfairly discriminates against dairy farmers, and that regional councils are already dealing with environmental issues through the Resource Management Act (RMA). Fonterra concedes that some of the environmental targets are covered by existing legislation. For example, Fonterra's current Suppliers Handbook states that issues contained in the Dairy Industry Environment and Animal Welfare Policies are important and that suppliers must meet their obligations in relation to the Regional Councils e.g. hold current resource consents and meet the conditions of these. However, Fonterra emphasizes that local councils are often constrained in their policing capacity, and that this ultimately damages New Zealand's image in international markets. The Accord along with Fonterra's Environmental Assessment could provide the credibility needed to support the clean and green claims.

Among a range of things the accord targets five issues identified as important. That includes that dairy farmers prevent stock access to major streams, rivers and lakes (unless the natural topography of the land prevents cattle access) and provide bridges or culverts on stock races through waterways, by 2012. Farmers should also adopt nutrient budgeting by 2007 to account for fertilizer and effluent applied to pastures.

Fonterra will assess each one of its 12,600 suppliers in the 2003/2004 season. Farmers who achieve immediate compliance (and this could be as high as 50 percent in the first round of assessments) will not be audited for another three years. Non-complying farmers will be given a chance to get their systems

³ Fonterra's supplier shareholders produce more than 95 percent of the national milk supply and alternative milk handlers are few in numbers and geographically limited, which leaves most suppliers no choice but to meet the environmental and animal welfare targets.

in order before they are re-assessed a few months later. Fonterra expects that suppliers will generally be willing to adopt the guidelines, as it should be in their best interest to ensure that the New Zealand dairy industry maintains its good overseas reputation.

Ministerial Approval for Milksolids Levy

A ballot conducted in May 2002, which sought the vote of New Zealand dairy farmers to decide on the statutory collection of a dairy industry levy under the New Zealand Commodity Levies Act 1990, resulted in a two-thirds support for the compulsory levy. The Minister of Agriculture has now recommended to the New Zealand Parliament to pass the appropriate legislation to enable the collection of the levy, beginning in June 2003. The total seasonal levy take which is estimated at NZ \$40 million in 2003/2004 will fund industry good activities such as research, promotion and education. The proposed levy is set at NZ 3.4 cents per kg. of milksolids but could be as high as 4.3 cents in the first year, depending on the total New Zealand milksolids production during the 2003/2004 season.

Dairy Industry Association of New Zealand

Since the restructuring of the New Zealand dairy industry in 2001, the industry has had no official, centralized dairy industry representation to compile and publish generic dairy industry information. Only the Ministry of Agriculture and Forestry has provided regular and comprehensive dairy industry updates. Apparently, the New Zealand dairy industry has realized that an official association representing the entire New Zealand dairy community is necessary. According to industry sources, the new association will be funded by individual companies according to the milk volume they supply, with the aim to produce and disseminate industry-wide statistics and information. The unnamed association is likely to be launched in June 2003.